EX PARTE NOTICE

July 25, 1996

William F. Caton
Secretary
Federal Communications Commission
1919 M Street, NW, Room 222
Washington, D.C. 20554

Dear Mr. Caton:

RE: Ex Parte Notice Filing, CC Docket No. 96-98

USTA hereby files an original and one copy of its response, including diskettes of model scenarios, submitted to Peyton Wynns, Chief, Industry Analysis Division, regarding AT&T's July 8 comments on the FCC's model. Please include a copy of this filing in the public record of this proceeding.

Respectfully submitted,

Keith Townsend
Director
Regulatory Affairs & Counsel

cc: Peyton Wynns
ITS

[redacted]

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WILLIAM E. TAYLOR
Senior Vice President

July 24, 1996

Mr. Peyton L. Wynns
Chief, Industry Analysis Division
Federal Communications Commission
2033 M. Street, N.W.
Room 500, Mailstop 1600F
Washington, DC 20554

Dear Mr. Wynns:

In this letter, I summarize NERA's analysis of AT&T's Comments pursuant to the Commission's Public Notice, DA 96-1007, IAD 96-175, released June 1996, regarding the Commission staff's Industry Demand and Supply Simulation Model (the IDSS model). I also enclose diskettes with the three scenarios addressed by AT&T's comments, as well as a fourth diskette with an alternative version of AT&T's Option 1. The diskettes are formatted so that they can be run on the FCC's Lotus software.[1]

AT&T claims that it "has made every effort to use reasonable assumptions...." and that "If the model has any value, it is to confirm the need to price unbundled network elements and access at TSLRIC." However, AT&T's use of the model serves only to exemplify AT&T's contention that the model "can be manipulated to achieve any result...."

I. AT&T MISCHARACTERIZES ITS RESULTS

AT&T's results are based on three scenarios:

- A Base case in which it assumes that the Act was not passed;

[1] Note that the results on the diskettes were obtained by inserting AT&T's assumptions into the IDSS model and then running the model. AT&T notes that it makes some corrections in the IDSS model [AT&T comments p. 4, footnote 4]. We have attempted, on the basis of its written description in that footnote to make the same changes in the IDSS model and in fact, have been able to closely match the results reported by AT&T in Table A of its comments.

- Option 1 which AT&T claims confirms:

> that the ILECs' proposals to price unbundled network elements based on their embedded costs, and gain simultaneous entry into the interexchange market, if adopted, would create enormous profits for the ILECs, to the detriment...of IXCs... CLECs [and] consumers. [AT&T Comments, p. 7.]

- Option 2 which, according to AT&T shows that:

> If prices for unbundled network elements were based on TSLRIC, however, consumers (residence and business) will be better off by more than $43 billion per year by 2002. [AT&T Comments, pp. 7-8.]

AT&T also claims that: (i) even by 2002 the ILECs will not suffer substantial losses in producer surplus (i.e., profit) under the TSLRIC based unbundling of network elements; and (ii) the IXCs and CLECs will "bear a proportionally greater share of this consumer benefit."

As shown in the next section, AT&T's use of the model is, in fact, an example of its contention that: "By varying the input assumptions, the Model can readily be manipulated to achieve any result the user desires." [AT&T Comments, pp. 1-2.]

II. THE EVIDENCE THAT AT&T HAS MANIPULATED THE RESULTS

A. AT&T's assumptions yield implausibly high growth in RoR

AT&T's manipulation of the model can be seen by the fact that "ILEC rate of return on rate base" is 16.2 percent in 1996 and 35.1 percent in 2002 even in its Base case, 72 percent in Option 1, and 28 percent in Option 2. [AT&T Comments, Table A, p. 8] These rates of return are inconsistent with the introduction of competition, especially in Option 2, in which the LECs are assumed to sell unbundled network elements to competitors at TSLRIC.

These results are generated by a number of factors; however, the following example shows how AT&T's assumptions lead to unrealistically high rates of return. Under Option 1, AT&T assumes that, in a single year from 1997 to 1998, LEC MTS revenues grow by $29 billion from $10.5 billion to $39.4 billion in 1998, while operating expenses increase by only $13 billion and Net Plant actually falls by $400 million in the same year, thus producing an increase in RoR of 9 percentage points from 18.3% to 27.5 %.

B. AT&T's Assumptions Are Unreasonable.

These unrealistic, enormous rates of return appear to have been generated by use of a number of unreasonable assumptions. Some of AT&T's more questionable assumptions and the manner in which they distort AT&T's results are summarized below.

1. Unreasonably Large LEC toll Market Shares

Option 1 assumes that the percent of residence customers who become LEC total bill customers reaches 35 percent in the first year the LECs enter the interLATA market (1998), and 53 percent by 2000 and 66 percent by 2002; and the analogous figures for business are 25 percent of by 1998, and 36 percent by 2,000 and 45 percent by 2002. Option 2 assumes smaller but still questionable LEC shares of total bill customers, reaching: 41 percent for residence and almost 23 percent for business, in 2002.

2. Unreasonably low IXC/CLEC local share gains

Option 1 assumes IXC/CLEC local shares (total bill percents) of:

	1997	1998	2000	2002
Residence	1.0	3.0	6.7	10.0
Business	1.5	4.5	10.1	15.1

Option 2 assumes IXC/CLEC local shares (total bill percents) of:

	1997	1998	2000	2002
Residence	2.0	10.0	24.8	38.2
Business	3.0	15.0	37.2	57.3

It should be kept in mind that: (i) AT&T assumes that IXCs/CLECs provide NONE of their own loops and NONE of their own switches in either Option 1 or Option 2 (They are assumed to provide all of their own loops in the base scenario, but their share never exceeds 1 percent of business loops, and they obtain NO residence loops in the base case, even in the sixth year of competition.); and (ii) in Option 2 the IXCs/CLECs obtain unbundled facilities from the LECs at extremely low wholesale prices. Since the facilities are already in place, and the IXCs/CLECs can enter without building any network facilities (according to AT&T's assumptions), we would expect IXC/CLEC market local share gains to occur much more rapidly.

3. Unreasonably low LEC costs for loops and toll entry artificially inflate LEC profits.

AT&T assumes that:

1. incremental loop investment is only $350 per loop [Specifications 135-137];
2. incremental loop cost is only $15 per month [Specification 99.]
3. the "IXC 'wholesale' price break to LECs for toll minutes that LECs resell" (for the non-access part of out of region interLATA toll) is 90 percent [Specification 36].

AT&T's first two assumptions clearly exaggerate the LECs' profitability in all cases by using low figures for network expansion and operation. The effect of the third assumption may be particularly important because the 90 percent discount implies that IXCs would be selling wholesale toll service to the LECs below the IXCs' own cost and that the LEC's cost of toll for their calls terminating out of region (i.e., 70 percent of the traffic per AT&T's assumptions compared to only 60 percent in the FCC's assumptions) will come to less than the cost of toll provided in region and less than the cost assumed for the IXCs' toll. Assuming that the non access interstate rate is about 15 cents to 10 cents, then the LECs are assumed to purchase toll from IXCs at only 1.5 cents per minute [15 cents x (1 - 0.9)] to 1 cent per minute. This artificially inflates LEC profits from toll, and artificially increases IXC losses from LEC entry. Furthermore the impact is quite large because AT&T assumes such large LEC toll market share and market size growth.

The results are dramatic for LEC profits. Simply reducing the 90 percent discount to 50 percent yields reductions in EBITDA of $7 billion to $12 billion, and comparable reductions in ROR. (If the actual discounts are smaller than 50 percent, the results would be more dramatic.)

	EBITDA with 90% discount	**EBITDA with 50% discount**	**ROR with 90 % discount**	**ROR with 50 % discount**
Option 1	$117 billion	$106 billion	72 %	60 %
Option 2	$ 73 billion	$ 67 billion	28 %	24%

4. Inconsistent assumptions regarding loop incremental costs and unbundled loop prices imply that AT&T has understated market share losses.

There appears to be a basic inconsistency in AT&T's assumptions for Option 1. In this case (and in the Base case) AT&T assumes that: (i) incremental loop cost are only $15.10 per month; and (ii) there would be no facilities-based competition, even though unbundled rates for loops would be set at about $30.00. (See discussion of Specifications 10 and 11 below.)

In AT&T Option 1, if the incremental cost for a loop were in fact only $15.10 and if the LECs charged $30.00 per loop per month for an unbundled loop, and over $30 per month for business loops sold to end users, then there should be substantial facilities-based entry. However, AT&T assumes no facilities-based entry [Specification 73] and no loops served by CLEC switches [Specification 72] throughout its study period. It makes no sense to assume there would be no facilities-based entry under these conditions, especially when the assumed end user business loop price (about $33.00 = $27.56 + a $5.23 weighted average single and multiline SLC) is substantially higher than the assumed incremental cost of service.

Specifications 10 and 11 -- Mark up from current incremental cost (CIC) for residence and business unbundled loops -- AT&T assumes this mark up is 100 percent in Base case and Option 1, i.e., AT&T assumes that the $13.66 residence rate would be more than doubled to about $30.00 when sold to the CLECs on an unbundled basis in 1997 and the business rate

increases by about $2.50 to $5.50 from the $27.56 average rate assumed for 1995. (In Option 2, AT&T assumes a 0% markup.) Coupled with AT&T's assumed low incremental cost, these assumptions create substantial profit and EBITDA from unbundled loops in Option 1. Using AT&T's assumption that all of the CLECs assumed 10 percent of residence and 15 percent of business loops in 2002 are provided using unbundled LEC loops, and AT&T's assumptions on access line growth, we calculated that its assumed mark-up increases profit by about $3.0 billion in 2002 in Option 1, compared to the Base case with no competition.

5. High markup for churn will offset LEC losses in Option 1.

Specification 9 -- Mark up from cost for one time charge for unbundling or churning a loop -- AT&T sets this mark up at 100 percent in Base case and Option 1. The FCC staff sets this at 0%. Since AT&T assumes the corresponding CIC for LECs is about $50 per line, the markup above costs would be about $50 per line. Thus, AT&T assumes that churn would be a significant source of profit for the LECs to offset losses in the first four years of competition in which AT&T assumes churn rates of 25 percent declining to 19 percent. In Option 2, AT&T assumes a 0% markup, which increases consumer surplus gains from this Option.

6. The extremely large assumed growth in the toll market will both raise consumer surplus and limit any financial losses for the LECs and IXCs/CLECs associated with lower toll

AT&T assumes growth in toll minutes from 1996 to 2002 is: 11% per year in the base case, 10% per year in Option 1 and 15% per year in Option 2. The resulting revenue growth also appears to be quite large in the base case (7.1% per year) and in Option 1 (7.5% per year); and significant, but smaller (4.3 % per year) in Option 2. Thus, despite the toll rate reductions assumed by AT&T (see next section), AT&T's forecast revenues grow substantially over time, even in Option 2, because of the dramatic usage growth assumed (especially in Option 2). AT&T's toll growth assumptions are unreasonably large when compared with actual growth using the most recent FCC data on the toll market. From 1984 to 1989 total industry toll revenue grew by only 5% per year and from 1989 to 1994 toll revenue grew by only 4% per year.[2] Thus, even with demand stimulation from lower prices, this level of growth is unrealistic.

7. Unsupported assumed toll price reductions drive much of AT&T's consumer surplus results.

Under AT&T's assumptions, prices (revenues per minute from all toll usage) decline, in the Base case from $0.153 in 1996 to $0.122 in 2002. In Option 1, the decline is smaller and the average is $0.133 per minute in 2002. In Option 2, on the other hand, toll prices are assumed to

[2] See FCC Statistics of Communications Common Carriers, 1994/95 Edition, Table 1.4, p. 7.

decline substantially more--dropping to only $0.085 per minute in 2002. These dramatically lower prices (coupled with the toll usage growth assumed to occur independently of price reductions) drive much of the consumer surplus gains. However, AT&T's toll price assumptions contain several flaws. The major problems are that AT&T assumes that: (i) the "non access component of toll rates before inflation" [Specification 45] will decline by 6% per year in every year (from 1996 to 2002) in both the Base case and in Option 2, but, in Option 1, this component declines only 5% in 1996, 1997, 1998 and 1999, stays unchanged in 2000, and actually increases by 1% and by 3%, in 2001 and 2002, respectively; (ii) the "Added price cuts to non-access portion of toll charges for:... All customers first year of LEC entry into interLATA" [Specification 51] is -15%, -20% and -25% in Option 2 in 2000, 2001 and 2002, respectively, but +2% in those years in Option 1; and (iii) IXCs will flow through 100% of access charge reductions to end users in every year considered by AT&T in the Base case and Option 2—an assumption that is not supported by past IXC pricing behavior—but, flow through only 90 percent of the reductions in the last three years of the analysis in Option 2 [Specifications 37 - 40].

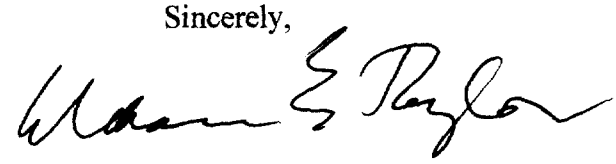
AT&T provides no basis for why smaller toll price reductions should be experienced in Option 1 than in Option 2 (or in the Base case which assumes no additional competitive entry in the interLATA market); nevertheless, AT&T assumes that this would occur in each year as described above and even assumes price increases in Option 1. The assumptions for Specifications 45 and 51 are inconsistent with AT&T's assumptions that: (i) there would be no LEC entry into the interLATA market in the Base case and, thus, no new pressure on the IXCs to lower toll rates; and (ii) in Option 1, that the LECs obtain a greater share of the long distance market than they would in Option 2. Contrary to AT&T's assumptions, there could very well be at least as much, if not more, competitive pressure on the IXCs to reduce rates in Option 1 as there would be in Option 2. Running the IDSS model changing only AT&T's assumptions for Specifications 45 and 51, i.e., assuming that the non access component of toll rates declines by the same amount in Option 1 as it does in Option 2 (but leaving AT&T's other assumptions unchanged), we find that: the $16.1 billion consumer surplus loss (-$7.3 billion residence and -$8.8 billion business) would become a gain of $28.9 billion. Furthermore, the "ILEC Surplus" gain of $25 billion is reduced by about $7.8 billion per year. Finally, making the same change in AT&T's assumptions, reduces the $59 billion consumer surplus gains reported by AT&T to $14 billion (i.e., by about $45 billion or by about 75%). Thus, with a single, unsupported assumption about the time pattern of toll rates, AT&T has demonstrated how it has been able to manipulate the model to support its policy agenda.

8. Questionable assumptions regarding discounts for CLEC customers.

Specifications 27 and 28 -- CLEC local rates as a percent of LEC monthly rates including SLCs for residence and business customers, respectively -- are assumed by AT&T to be 90 percent of LEC rates. This coupled with $2.25 "total bill" customer discount in 2002, implies that as market shares of CLECs (in 2002) increase from about 0% in Base case, to 10% residence and 15% business in Option 1 and to 38% residence and 57 % business in Option 2, the latter option will generate a substantial gain in consumer surplus. This is questionable because it

unrealistically implies that CLECs would be willing to sell residence loops at prices that were substantially below the unbundled rates they pay the LEC.

Sincerely,



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Attachment A

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